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Bruce H. Johnson

*Member, Indiana Bar*

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## FEDERAL TAXATION OF TENANTS BY THE ENTIRETY

BRUCE H. JOHNSON\*

Undoubtedly the most common method of holding title to Indiana real estate where the purchaser is married is in tenancy by the entirety. The advantages attributable to such a method and which have caused its popularity have not changed, but the comparatively recent impact of federal estate, gift and income taxes, especially in view of the recent reductions in credits and exemptions, requires an examination of the comparative disadvantages of this method of holding legal title to determine whether its popularity is now deserved.

The legal characteristics of the tenancy by the entirety which have been the source of that popularity are (1) transfer of title to the surviving spouse upon the death of the co-tenant is automatic and is free from our State inheritance tax; (2) the property may not be levied upon by a judgment creditor of one spouse only; and (3) the interest of one tenant can not be affected by an attempted conveyance to a third party by the co-tenant.

These considerations are still appropriate but their importance, practically, is becoming increasingly limited in our present day economic society. Title requirements are easily satisfied by administration, which is usually necessary anyway. Our inheritance taxes are assessed at rates so much lower than those of the Federal Government as to be relatively insignificant in larger estates, especially since inheritance taxes paid may be credited against 80% of the basic federal estate tax.<sup>1</sup> The wide-spread use of liability insurance today removes the fear of loss of property to judgment creditors for tort; and the greater protection afforded married women in their property rights makes rare the necessity for protection of the wife's interest in real estate from the husband. In some instances, the original considerations will still be dominant in determining the method of holding title to real estate by husband and wife. But in the many instances where these considerations are relatively unimportant, the treatment by the taxing authorities of the income derived from the property

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\* Of the Indiana bar.

1. Int. Rev. Code, Sec. 813(b).

and of the receipt of money or property on account of the change in legal title through survivorship, sale or gift may afford sufficient basis to disregard the historical reasons for holding real estate as tenants by the entirety.

### Federal Estate Tax

The Internal Revenue Code provides that there shall be included in the gross estate of the decedent for the purpose of determining the amount of estate tax owed, the value of property held by the decedent as a joint tenant with any other person or as a tenant by the entirety. An express provision requires the inclusion in the gross estate of the decedent of that part of the value of the tenancy acquired by gift from the decedent. Thus the surviving wife's interest in property acquired by the decedent husband and held by them in a tenancy by the entirety does not serve to reduce the portion of the property taxable to the decedent except in those cases where the wife herself furnished some consideration in money or money's worth for the acquisition of her interest, and then only to the extent of her contribution.<sup>2</sup>

Every Revenue Act since 1916 has contained provisions to this effect. Their constitutionality and the above interpretation were upheld by the Supreme Court of the United States in the case of *Tyler v. United States*<sup>3</sup> and in *Helvering v. Bowers*.<sup>4</sup>

Where the title is held by the husband and wife as tenants in common without right of survivorship, there is includible in the estate of each spouse only one-half the value of the property<sup>5</sup>

Because of the progressive estate tax rates, the tax attributable to a parcel of real estate held by the entirety may be more than double the amount owed with respect thereto if husband and wife were tenants in common.

Although the amount of the exemption for additional estate tax was increased by the Revenue Act of 1942 from \$40,000.00 to \$60,000.00, the exclusion for life insurance up to \$40,000.00 was eliminated at the same time. This has

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2. *Idem*, Sec. 811(e) (1).

3. 281 U.S. 497 (1930).

4. 303 U.S. 618 (1938).

5. *Estate of I. A. Smith*, 45 BTA 59, Dec. 12,065; *Estate of E. Mead*, BTA Memo Opinion, Dec. 12,507-D.

resulted in an increasing number of estates subject to federal estate tax.

### Federal Gift Tax

Section 1000 of the Internal Revenue Code imposes a tax upon the transfer of property by gift, and the word "transfer" is broadly defined. The statute does not enumerate the transactions to be considered, but the Regulations promulgated by the Commissioner of Internal Revenue are more explicit.<sup>6</sup> "Transfer" has been held by the Courts to include the acquisition of an interest by a spouse in real estate held as tenants by the entirety where the other spouse furnished the consideration therefor.<sup>7</sup>

It is clear that wherever, as in Indiana,<sup>8</sup> the right of a survivor can not be defeated by the action of either tenant by the entirety, acting alone, a gift subject to the Act has been made whenever one spouse furnishes more of the consideration than is proportionate to his interest as determined under the Commissioner's regulations. In valuing the right of each of the spouses, it is necessary to determine whether, under the local law, the right to the income or other enjoyment of the property must be shared or whether the income and right to possession belongs exclusively to the husband. The pertinent law in Indiana on this matter will be discussed in its relation to the income tax, and it is sufficient to say here that in the case of *Lilly v. Smith*, supra, the Court held that the Commissioner had properly included in the value of the gift the value of the wife's right to the present enjoyment of the property during their joint lives, as well as the value of her right of survivorship.<sup>9</sup>

6. Treas. Reg. 108, Sec. 86.2(a) (6).

"If a husband with his own funds purchases property and has the title thereto conveyed to himself and wife as tenants by the entirety, and under the law of the jurisdiction governing the rights of a tenant there is no right of severance by which either of the tenants, acting alone, can defeat the right of the survivor to the whole of the property, he consummates a gift of such property valued as provided in Sec. 86-10(h)."

7. *Lilly v. Smith*, 96 F. (2d) 341 (1938), cert. den., 305 U. S. 604 (1938); *Commissioner v. Hart*, 106 F. (2d) 269 (1939); *Commissioner v. Logan*, 109 (2d) 1014 (1940).

8. *Sharpe v. Baker*, 51 Ind. App. 547, 99 NE 44 (1912).

9. Although the issue to be determined is the same when considering divisibility of income for separate income tax returns of tenants by the entirety as when considering the inclusion of the wife's right to income or present enjoyment as an element of value for

The Regulations recognize<sup>10</sup> the difficulty to be encountered in the computation of proportionate parts of value with the use of mortality tables, and permit the submission of the data to the Commissioner who will make the required calculations.

In the case of *Lilly v. Smith*, supra, the total value of the real estate purchased was \$300,000.00. The parties agreed on the determination of the wife's value at \$72,599.50 for her interest during their joint lives, and the value of her right of survivorship at \$73,025.00, making a total taxable gift of \$145,624.50.

If title to the property had been taken by the same parties as tenants in common and without right of survivorship, a gift would have been made to the wife of one-half of the value or \$150,000.00.

It might be well to remark that when the donor dies and if the value of the property given is includible in his estate, the gift tax paid may be credited on the estate tax of the decedent, subject to certain limitations.<sup>11</sup>

The practical benefit of this credit is not as substantial as would first appear, however, since the estate tax on the value of the property included is ordinarily much greater than the gift tax paid. For example, if the gift tax on the purchase of a \$20,000.00 home is \$200.00 and the net estate of the spouse who furnished the purchase price is valued at \$110,000.00, the addition of \$20,000.00 to his net estate increases the maximum estate tax from \$7,000.00 to \$12,300.00.

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the gift tax, a decision on this issue for one tax is not necessarily an authority with respect to the other, the two taxes being separate, distinct and unrelated to each other. *Higgins v. Commissioner*, 129 F. (2d) 237, cert. den. 317 U. S. 658 (1942).

10. Treas. Reg. 108, Sec. 86.19(h) "Tenancies by the Entirety"  
". . . The value of the gift is the value of such property less the value of the right, if any, of the donor spouse to the income or other enjoyment of the property, or share thereof, during the joint lives of the spouses, and the value of the right of the donor spouse to the whole of the property should he or she be the survivor of them. The value of each of such rights is to be determined in accordance with the Actuaries or Combined Experience Table of Mortality, as extended."
11. Int. Rev. Code, Sec. 813(a): This position is urged by the Commissioner in the case of *Lilly v. Smith*, supra, and the Court upheld that contention saying, page 344:  
"The fact that the estate of the decedent must pay an estate tax on the entire value of the fee simple upon the death of the spouse would be more persuasive if the same statute (the Estate Tax Act) did not provide for a credit of the amount paid as Gift Tax on the Estate Tax."

Two hundred dollars is a relatively insignificant credit compared with such an increase. Incidentally, \$2,800.00 of this increase in tax is avoidable by having the title taken in tenancy in common.

### Federal Income Tax

The Federal Estate Tax, affecting gross estates in excess of \$60,000.00 value only, and the gift tax, with annual exclusions of \$3,000.00 to each donee and a specific lifetime exemption in addition of \$30,000.00, affect only a relatively small group of our citizenry. The Income Tax Law, however, levies a tax on every individual who has a net income of more than \$500.00 in any year, and the treatment of income from property held as tenants by the entirety is therefore of extensive application. It is to be regretted that in only a very few jurisdictions is there any substantial authority for determining who must report and pay tax on the income from property so held.

The Internal Revenue Code provides for the levy of a tax upon the "net income of every individual."<sup>12</sup> "Net income" is defined as the "gross income less the deductions allowed,"<sup>13</sup> and "gross income" is defined to include "gains, profits and income derived from . . . businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rents, dividends, securities . . . or gains or profits and income derived from any source whatever . . ."<sup>14</sup> But where the property involved is owned by husband and wife as tenants by the entirety, does the husband alone, or the wife alone, or do both of them become entitled to the income and therefore become obliged to pay tax on that income? The answer to this question requires a determination of the legal right to the possession or income of property held in a tenancy by the entirety, and as the legal incidents are governed by the different rules of law in the various jurisdictions in the United States, the answer can be obtained only by an analysis of the law pertaining to tenancies by the entirety in each particular state. Unfortunately, Federal decisions and rulings of more or less authority have

12. Int. Rev. Code, Sec. 11.12(b).

13. Idem, Sec. 21.

14. Id. Int. Rev. Code, Sec. 22.

been published in respect of six states only: Massachusetts, Michigan, Florida, Maryland, Missouri and New York.

The first authoritative opinion, setting the pattern for the consideration of this matter and providing the rationale for subsequent decisions, is *Cooley v. Commissioner*.<sup>15</sup> The appellant and his wife were residents of Massachusetts, and held certain stocks and bonds as tenants by the entirety, each reporting for the year 1929 on separate income tax returns one-half of the interest and dividends received. The Board of Tax Appeals sustained the Commissioner's action in including all of the income in the gross income of the husband, and the question to be determined, as stated by the court, was:

"whether the entire income arising from property held by a husband and wife domiciled in Massachusetts as tenants by the entirety is taxable to the husband."

The court analyzed decisions of the Massachusetts Supreme Court and determined that the husband's interest in a tenancy by the entirety included the right during his lifetime to the entire net income from such property to the exclusion of the wife, the common law not having been modified in that respect in Massachusetts.

During the same year, 1935, the Circuit Court of Appeals for the Sixth Circuit reached an opposite result in considering the law of Michigan governing the rights of tenants by the entirety.<sup>16</sup> The Commissioner had appealed from an order of the Board of Tax Appeals which determined that the interest paid on the deferred installment of a contract for the sale of property owned as tenants by the entirety was taxable one-half to the husband and one-half to the wife. The Board based its conclusion on its belief that although the real estate had been held in a tenancy by the entirety, when the real estate was sold the right to the proceeds was held in joint tenancy and not by the entirety. The Circuit Court of Appeals determined that the proceeds from the sale of the land retained the same legal characteristics of a tenancy by the entirety, but it went further and held that the applicable Michigan cases required the conclusion that the wife in Michigan had a right to the income equal to that of her co-tenant husband, pointing out that:

15. 75 F(2d) 188, cert. den., 297 U.S. 747 (1935).

16. *Commissioner v. Hart*, 76 F. (2d) 864 (1935).

. . . payments due upon a contract for the sale of land held by husband and wife as tenants by the entireties can not be reached in garnishment by the husband's creditors, . . . rent from property so held is not subject to garnishment by creditors of the husband, and . . . the rents, profits or income of such property is not subject to process under a judgment creditor's bill in equity at the instance of the husband's creditors.

Other rulings and decisions have considered, in determining whether the common law rule which permitted the husband to enjoy the control and use of income from the wife's property had been changed in the various jurisdictions, the following factors of state law:

The effect of the passage of Married Women's Property Acts upon estates by entireties<sup>17</sup>;

Decisions holding the rights of the wife as much entitled as those of the husband to equal protection<sup>18</sup>;

The effect of the granting of a divorce to the tenants and the division of interest thereunder<sup>19</sup>;

The right of the wife to a share of the crop or other "fruit" of the property<sup>20</sup>.

Although an early ruling discussed as a factor the consent of the husband and wife that the income or profits should be shared, this consideration is no longer valid in view of the decisions of the Board of Tax Appeals that the profits may not be allocated to either as the parties may agree, but, if divisible at all, must be apportioned equally.<sup>21</sup>

The writer believes that an application of these tests to the decisions in Indiana requires the conclusion that the income from a tenancy by the entirety is divisible equally between the husband and the wife and may be so reported on their separate income tax returns.

The case of *Patton v. Rankin*,<sup>22</sup> involved the attempt by a judgment creditor of the husband to levy execution on a crop raised on land owned by him and his wife as tenants

17. I.T. 2381, VI-2CB118 (Missouri); District and Security Trust Company, et. al., Executors, vs. Commissioner, 20 BTA 136 (Mich.); *Saulsbury v. Commissioner*, 27 BTA 744 (Maryland).

18. G.C.M. 3111, VII-1CB112; I.T. 3235, 1938-2, CB 160 (Florida).

19. I.T. 2381, VI-2CB118 (Missouri).

20. District and Security Trust Company, et al., Executors, v. Commissioner, 20 BTA 136 (Mich.); *Saulsbury v. Commissioner*, 27 BTA 744 (Maryland).

21. *Saulsbury v. Commissioner*, 27 BTA 744; *Upthegrove v. Commissioner*, 33 BTA 952.

22. 68 Ind. 245 (1879).



by the entirety. The court held that the crop itself was owned by the husband and wife in the same manner as the land and was not, therefore, subject to levy and sale on an execution against the husband.

This case relies for its authority upon the case of *Chandler, by Moore, Guardian, v. Cheney*.<sup>23</sup> That case contains an exhaustive analysis of the legal incidents of the estate of a tenancy by the entirety in Indiana, and the changes in those rights occasioned by the Acts of the Legislature with reference to women's property rights, saying of those various Acts, on page 414:

"... we think that it is quite manifest that the legislature intended to deprive the husband of the control over the property of the wife, which he had enjoyed by the common law. It is well settled by all the authorities, that an estate, by entirety belongs as well to the wife as to the husband . . . It is quite clear to us that when the legislature provided that husband and wife should not be tenants in common, but by entireties, the intention was to guard and protect the rights of the wife by depriving the husband of the power to alien or encumber the same without her consent and concurrence, or to charge the same with his debts, or to exercise sole control, or to enjoy exclusive possession thereof."

The question was re-examined by the Indiana Appellate Court in the case of *Sharpe v. Baker*.<sup>24</sup> In the course of the opinion, Lairy, J. said, page 556:

"By statutory enactment in this State, married women have been emancipated from most of the common law disabilities. As a result of such statute, the husband is no longer entitled to the possession and control of the separate real estate of his wife, and therefore, he has no right to the rents and profits thereof during coverture. By force of the same reasoning, it must be true that the husband, under our statute, is not the owner of the rents and profits of estates held by himself and wife as tenants by the entireties, and that he has no right to the exclusive possession and control thereof during coverture."<sup>25</sup>

In Indiana, as in most States, it has been held that the granting of an absolute divorce destroys a tenancy by the entirety and creates a tenancy in common. The rights of the parties as tenants in common are equal.<sup>26</sup>

If further persuasive showing of the equal treatment

23. 37 Ind. 391 (1871).

24. 51 Ind. App. 547 (1912).

25. At page 446. See also Women's Property Acts in 28 Va. L. Rev. 608-622.

26. *Lash v. Lash*, 58 Ind. 526 (1877); *Sharpe v. Baker*, supra or 24.

in Indiana of the tenants by the entireties were necessary, that is supplied by the division of the income from such property for purposes of the gross income tax,<sup>27</sup> and by the previously cited gift tax case of *Lilly v. Smith*.

Of course, if the husband and wife take title as tenants in common and without right of survivorship rather than as tenants by the entireties, as they may do in Indiana,<sup>28</sup> the income from such property is apportioned equally for federal income tax liability. It necessarily follows from what has ants by the entirety, the gain or loss is equally divisible and may be so reported on their separate income tax returns.

The basis to be used in determining the gain or loss, upon disposition by the surviving tenant, is the same basis that would have been used on disposition by both tenants.<sup>29</sup>

*Lang v. Commissioner*,<sup>30</sup> illustrates one serious tax disadvantage in holding property as tenants by the entirety during a period of rising real estate values. The petitioner and her deceased husband had purchased real property in 1915 at a cost of \$13,000.00, of which the wife contributed \$1,560.00, or 12%. In 1924, when her husband died, the property had a value of \$40,000.00 and 88% of that amount was properly included for federal estate tax on the estate of her deceased husband. In 1925, the property was sold for \$40,000, and in reporting the sale, the petitioner sought to use as her basis for gain the amount of her own contribution, \$1,560.00, plus the valuation taxed as her husband's former interest in the property, or a total basis of approximately \$36,760.00. The court discussed the legal characteristics of an estate by the entirety, and determined that she had acquired no greater title by the death of her husband, and, having received nothing by reason of his death, her basis for gain or loss had to be determined from the cost of the property in 1915, \$13,000.00. The court recognized that a special hardship was imposed, but felt powerless to change by construction the meaning of the statute.

Suppose Mr. and Mrs. Lang had purchased this property not as tenants by the entirety, but as tenants in common.

27. Ind. Gross Income Tax Reg., Reg. 1300; 2 Horack, Ind. Adm. Code § Rule 64-2601-35.

28. Thornburg, et al. v. Wiggins, et al., 135 Ind. 178, 34 N. E. 999 (1893).

29. *Lang v. Commissioner*, 289 U.S. 109 (1933).

30. *Supra*, n. 29.

This would have resulted in his making a gift to her in 1915 of the difference between one-half of the cost of the property and her contribution, or a net gift of \$4,940.00. Upon the husband's death in 1924, there would have been included in the husband's estate only \$20,000.00, and his estate tax would therefore have been reduced by the amount of tax payable on the top \$15,200.00 of net estate subject to tax. Besides this saving, in 1925, when the property was sold, Mrs. Lang would have had a basis for gain of \$26,500.00, the sum of her basis for her own undivided one-half interest, \$6,500.00, and that of her deceased husband acquired by inheritance, \$20,000.00. Under our present income tax law, the saving in income tax under this method might well have been slightly more than \$2,500.00 in comparison with the tax resulting from the sale as a surviving tenant by the entirety.

### Summary

Substantial savings in federal estate taxes may be made if purchased Indiana real estate is owned by husband and wife as tenants in common and not as tenants by the entirety.

Wherever one spouse has furnished most of the purchase price for real estate, and that person's net estate may on his death exceed \$60,000 in value as computed under the Internal Revenue Code, serious consideration should be given to the advisability of changing the title to real estate from a tenancy by the entirety to a tenancy in common.

In this period of rising real estate values and threatened inflation, such a change may have further advantages to the surviving tenant in income tax savings on subsequent disposition of the property.

Gifts are made whenever one spouse's contribution to the purchase price exceeds the value of his proportionate interest in the property received. The difference in federal gift tax owed, if any, is slight, whether title is taken as tenants in common or as tenants by the entirety. But in the former case, the interest given is subsequently excluded from the net estate of the donor spouse in computing federal estate tax, while in the latter case, no exclusion is permitted on account of the gift.

For federal income tax accounting, the income from real estate in Indiana is subject to the same treatment, whether

title is held by entireties or in common, and if separate returns are filed, the income is equally divisible between husband and wife.

It would, therefore, appear that wherever the purchasing spouse's net estate may be subject to the imposition of a federal estate tax, ownership of real estate as tenants in common offers a substantial tax advantage. In other instances the historical benefits incident to the estate by the entirety will probably outweigh other considerations.

